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Planned Giving News—Spring 2001

IRAs as Planned Gifts

The IRS recently released rules that substantially improve the distribution process for IRAs and qualified retirement accounts. The changes are clearly investor friendly and offer an opportunity to discuss new IRA strategies with prospective donors. Even if donors have already begun taking withdrawals under the old rules, they are no longer locked in to the original calculation method. While the new rules are expected to become mandatory in 2002, one has the option of using them now.

Calculating minimum required distributions has been greatly simplified. Nearly everyone will use one table, with much higher life expectancies, resulting in lower minimum distributions. The opportunity to reduce withdrawals will allow investments to accumulate value tax-free for a longer period of time, resulting in a larger asset for heirs or favorite charities. In most cases, the life expectancy used no longer depends upon the age joint beneficiaries. The only exception is if the spouse is junior by ten or more years. In that case, a joint life expectancy table is used, and the result is even more beneficial.

Beneficiary designations are also liberalized. Donors may now change the beneficiary without restriction, even if they have already started taking distributions. Moreover, the

final designation of a beneficiary will not be determined until December 31st of the year following the death of the IRA owner. This lag time means that beneficiaries have many more options than before. A beneficiary such as a charity may choose to “cash out” its interest, leaving the remaining heirs to divide the balance of the IRA into separate accounts and use their life expectancies for withdrawals. Development officers should consider discussing with prospective donors a bequest intent for IRA dispositions.

These changes open up options that may have been impractical before. A donor may designate a CRT to receive assets at death and name a charity as a remainder interest with family members receiving income.

One change has not been determined. That, of course, is the estate tax issue. It is currently being debated and the outcome is uncertain. Currently, estate tax may be due on an IRA bequest, and one should pre-plan where the funds needed to pay the estate tax will come from. Naming a charity could eliminate this problem. The new rules put an IRA bequest on a footing comparable to a CRT. This represents a golden opportunity for charities as well as donors wishing to enhance the impact of their estate plan.

Jim Fox

Planned Giving Strategies-Part II

In order to help you fully understand the issues addressed in this article, we have provided an insert with a brief background on the Uniform Prudent Investor Act, the 4-Tier Tax System of Characterizing Beneficiary Distributions, and the Calculation of Charitable Deductions.

There are various forms of planned giving arrangements, each with unique characteristics that have evolved to address specific donor needs. This is the final installment of a two-part article which identifies these characteristics and needs, and explains the corresponding investment approach applicable to the following types of arrangements:

- 1) Charitable Gift Annuities
- 2) Charitable Remainder Annuity Trusts
- 3) Pooled Income Funds
- 4) Charitable Remainder Unitrusts
 - Standard (no net income limitation)
 - Net Income with Makeup
 - Net Income with no Makeup
 - Flip

The first installment of this article was published in our Fall 2000 *Planned Giving News* and addressed Charitable Gift Annuities and Charitable Remainder Annuity Trusts. This installment focuses on Pooled Income Funds and the various types of Charitable Remainder Trusts.

Pooled Income Funds - Explained

A donor to a pooled income fund acquires a specific number of units in an investment pool based on the pool's unit value at the time of gift. The distributable income earned by the investment pool is paid to the beneficiaries based on the number of units held by each participant in the pool.

Like annuity trusts and unitrusts, the type and amount of taxable income reportable by the

beneficiary from the receipt of pooled income fund distributions is based on the amount and type of income earned by the underlying investments under the 4-tier system.

Pooled Income Fund - Strategies

Like gift annuities, pooled income funds are most appropriate for several small gifts. The gifts are held in an investment pool that is easier to administer than would be several separate annuity trusts or unitrusts. Unlike gift annuities and annuity trusts, the payments are not fixed but fluctuate with the timing, type, and amount of income earned by the investment pool.

Pooled income funds cannot hold tax-exempt securities and capital gains are often not distributed to the beneficiaries. This leaves only taxable interest and dividends as the source of the beneficiary distributions and the payments are taxed to the beneficiary as *tier-1* ordinary income.

To provide adequate distributable income, pooled income funds are generally invested in bonds, which reduces long-term total return and the amount that will eventually be paid to the charitable remainder. Recently, due to low yields on bonds, pooled income funds have fallen out of favor with donors due to the low level of beneficiary distributions.

Pooled income funds with young life beneficiaries could initially pursue a growth strategy through low dividend equity investments at the expense of current beneficiary distributions. As the beneficiaries age the enhanced portfolio could be shifted to bonds increasing the amount paid to the beneficiaries at a time when the beneficiary's other sources of income may be diminishing.

Charitable Remainder Unitrusts - Explained

Like annuity trusts, a charitable remainder unitrust is a separate legal entity created by the transfer of assets to a trust governed by the terms of a trust agreement. A **standard unitrust** makes periodic payments to an income beneficiary based on a percentage (*payout rate*) of the trust's value. The unitrust must be revalued, and the income beneficiary distributions recalculated, at least annually. Upon the unitrust's termination, which may occur on the death of the beneficiary or after a specified number of years, the amount remaining in the unitrust is transferred to a charity.

A **net income unitrust** is an arrangement where the amount distributed to the beneficiaries is the lesser of (1) the *payout rate* applied to the trust's assets computed at least annually (*percent limitation*), and (2) the *distributable trust income* for the calendar year. The unitrust agreement will specify the *payout rate* and define distributable trust income.

The net income unitrust agreement may include a **makeup** provision that takes into consideration the *cumulative shortfall*, or the amount by which the prior years' *percent limitations* exceeded the *distributable trust income*. The *cumulative shortfall* is added to the current year's *percent limitation* to determine the maximum amount payable to the beneficiaries subject to the current year's *distributable trust income*.

A **flip unitrust** is an arrangement that begins as a net income unitrust then converts (flips) to a standard unitrust at a predetermined time or upon the happening of an event such as the sale of unmarketable securities. Like pooled income funds and annuity trusts, the type and amount of taxable income reportable by the beneficiary from the receipt of unitrust

distributions is based on the amount and type of income earned by the underlying investments under the *4-tier system*.

Charitable Remainder Unitrusts - Strategies

Unlike gift annuities and annuity trusts, the amount paid to **standard unitrust** beneficiaries changes each year based on the change in the value of the trust assets. Unitrust beneficiaries share in any appreciation of trust assets in that their distributions will increase. Conversely, the beneficiaries share the investment risk with the charitable remainder since the beneficiary distributions will decline if the value of the trust assets decline. Donors who are able to accept this uncertainty in the amount distributed to the beneficiaries yet appreciate the long-term potential of increased distributions find unitrusts appealing.

Additional contributions may be made to a unitrust but not an annuity trust. A unitrust is therefore the only trust arrangement for donors who intend to make additional gifts of the same type and want to avoid creating additional trusts.

As with all investment portfolios, increased exposure to equities increases portfolio risk and expected long-term total return. The longer the expected duration of the unitrust, the smaller and more manageable is the overall risk from the variability of short-term returns associated with equity investments. This risk is further reduced since, in general, the amount paid to the beneficiaries will only increase if the value of the investments increases and will decline if the value of the investments decline. Net income unitrusts, however, enable the trustee to further vary the amount paid the beneficiaries by manipulating the unitrust's recognition of *distributable income*.

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Net income unitrusts present additional issues and opportunities. Since distributions are limited to *distributable income* and the trust can define *distributable income*, the donor is given more tools to deal with unique circumstances. Funding a unitrust with unmarketable securities would present a liquidity problem in making the beneficiary distributions. Also, the donor may not want the trust to make beneficiary distributions until some later date as in a retirement plan equivalent.

Distributable income could include only interest, dividends, rents, and royalties received by unitrust investments. This would solve the liquidity problem of unmarketable assets since the beneficiary distributions would be limited to the liquid assets received as interest, dividends, rents, and royalties.

Equities and their low dividends could satisfy the retirement plan motive in the early years of the unitrust followed by a movement into bonds thereby increasing the *distributable income* paid to the beneficiary in the later years of the unitrust when the beneficiary's other sources of income may be diminishing.

The increase in the amount paid to the beneficiary if the unmarketable investments are sold or the portfolio moves from equities to bonds could be further enhanced with a **makeup provision**. With sufficient distributable income, the unitrust would distribute not only the amount determined by the periodic value of the trust assets (*percent limitation*) but also the cumulative amount by which the prior

year's *percent limitation* exceeded the *distributable income* paid to the beneficiaries (*makeup amount*).

Flip unitrusts eliminate the burden of earning the right type of income at the right time after the reasons for the net income limitation no longer exist. A flip unitrust could be created that drops the net income limitation and converts to a standard unitrust when the unmarketable assets are sold or when the beneficiary reaches a certain age. However, any *makeup amount* is lost with the conversion to a standard unitrust.

The tax strategies available for annuity trusts are also available for unitrusts. Minimizing ordinary income to the beneficiary through equity investments and tax-exempt bonds, and the management of donated appreciated securities apply to unitrusts as they do for annuity trusts.

The charitable deduction available to a donor creating a unitrust depends, in part, upon the amount that could be paid to the beneficiaries. It does not matter whether this amount is actually paid as in a standard unitrust or merely a limitation subject to the distributable income as in a net income unitrust. A higher charitable deduction is not available to a net income unitrust donor merely because of the possibility that actual beneficiary distributions will be less than would be paid by a standard unitrust.

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